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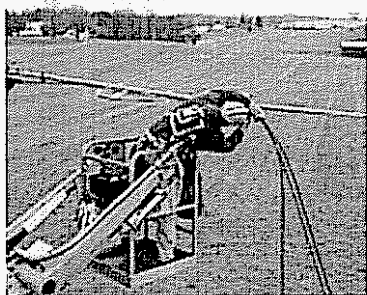


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## Fees paid by all phone customers help rural phone firms prosper

By Paul Davidson, USA TODAY

The regional Bell phone giants are struggling. AT&T and MCI are on life support. But tiny XIT Rural Telephone Cooperative is humming along nicely.



Contractor Don Harvey of Doylestown Telephone in Ohio strings fiber-optic cable in rural Chippewa Township.

By Greg Ruffing for USA TODAY

The utility, which serves 1,500 ranchers, farmers and others in the Texas Panhandle, fared so well last year that it doled out a fat dividend to its customers, who also own it: an average \$375 — more than the average \$206 each customer paid in local phone fees.

Meantime, the co-op took in \$2.6 million in federal universal service revenue. That's what people across the USA pay, through an 8.9% fee on long-distance bills. It subsidizes service in rural areas, where it's far costlier to run wires.

XIT also got \$650,000 in state universal service fees and \$2.9 million in access charges. Long-distance carriers pay access charges to connect their calls. Those, too, get passed on to consumers. Universal service and access fees help keep service affordable in rural areas so the entire USA can stay connected.

But critics say the system is laced with waste and inefficiency. They point to some rural phone companies' high overhead, sumptuous earnings, rich dividends and, at least in one case, fraud. Oversight has been lax: Prosecutors say the Gambino crime family was able to fraudulently draw millions from the universal service fund from 1996 to 2003 by controlling a Missouri rural phone firm. And critics say customers around the USA are stuck with the bill.

The howls have grown louder this year. Regulators are paying closer scrutiny, launching a probe and expanding audits. They're also preparing to revise the fee system. Those steps could erode the decades-old pillars of rural phone service.

"The system is broken," says John Stanton, CEO of Western Wireless, which competes with rural providers for some customers. The subsidies, Stanton charges, are "an incentive for abuse."

But rural phone officials insist abuse is rare. Jimmy White, who manages XIT, says the co-op's earnings fall within state limits. Rural providers say the universal service fund is strained because of Western Wireless and other rivals, which get some of the fund's revenue to aid rural cell phone service. Rural providers say the cell phone carriers don't need subsidies.

FUNDING BY STATE

Complaints about rural subsidies aren't new.

Universal service funding, which supports phone service in high-cost rural areas, by state:

State	Total 2003 support
Alabama	\$92,278,000
Alaska	\$85,708,000
Arizona	\$69,412,000
Arkansas	\$113,980,000
California	\$90,924,000
Colorado	\$74,869,000
Connecticut	\$2,245,000
Delaware	\$3,489,000
Dist. of Columbia	\$0
Florida	\$79,463,000
Georgia	\$116,172,000
Hawaii	\$11,263,000
Idaho	\$53,286,000
Illinois	\$52,095,000
Indiana	\$53,450,000
Iowa	\$72,390,000
Kansas	\$108,470,000
Kentucky	\$60,264,000
Louisiana	\$90,195,000
Maine	\$32,039,000
Maryland	\$3,675,000
Massachusetts	\$1,712,000
Michigan	\$45,985,000
Minnesota	\$80,133,000
Mississippi	\$170,660,000
Missouri	\$91,145,000
Montana	\$67,407,000
Nebraska	\$43,770,000
Nevada	\$31,378,000
New Hampshire	\$12,425,000
New Jersey	\$1,342,000
New Mexico	\$49,231,000
New York	\$53,134,000
North Carolina	\$71,773,000
North Dakota	\$55,103,000
Ohio	\$39,022,000
Oklahoma	\$103,950,000
Oregon	\$72,114,000
Pennsylvania	\$56,002,000
Rhode Island	\$46,000
South Carolina	\$83,944,000
South Dakota	\$47,909,000
Tennessee	\$53,939,000
Texas	\$206,622,000

Lawmakers have long shielded the payments as a way to cap rural phone rates.

Rural carriers "have a whole lot of support in Washington," says Legg Mason analyst Chris King. "No one wants to upset the apple cart."

"We're desperately concerned," says Ken Pfister, vice president of Great Plains Communications, which serves 33,000 customers in Nebraska. Scrapping access fees alone would trigger a \$20 monthly phone-bill increase, Pfister says.

About 10% of the USA's phone lines are in rural areas, from the northern plains to the Southwest.

Many are run by small family-owned phone companies and co-ops that sprang up early in the 20th century in out-of-the-way areas shunned by big carriers.

Rural residents are expensive to serve. It can cost thousands to run a cable 20 miles to an isolated farmer. To compensate, AT&T in the 1950s began paying access fees to rural providers to connect long-distance calls of rural customers.

After AT&T's breakup in the 1980s spawned long-distance competition, long-distance prices plunged. So did access fees.

To sustain rural providers, the government created the universal service fund. (The fund also subsidizes

Utah	\$23,849,000	rural health care, low-income phone users and telecommunication services in schools and libraries )
Vermont	\$28,084,000	
Virginia	\$77,303,000	
Washington	\$81,800,000	
West Virginia	\$80,169,000	
Wisconsin	\$91,763,000	Some academics and industry officials have long questioned the notion that people across the USA must subsidize rural phone service.
Wyoming	\$46,856,000	
Source: Universal Service Administrative Co		

"Why should some poor single mother in Boston pay extra money to make sure someone in a rural area is doing fine?" says Brad Wimmer, a former Federal Communications Commission official who teaches economics at the University of Nevada, Las Vegas. City dwellers, Wimmer notes, pay more for parking than rural residents.

But rural officials call the analogy flawed. City dwellers, they say, benefit by being able to call friends and relatives in rural areas.

"We don't think it's right public policy to say, 'If they can't afford it, too bad,' " says Dan Mitchell, senior regulatory counsel for the National Telecommunications Cooperative Association (NTCA).

The subsidies and a scarcity of competition in their areas have helped rural companies fare well in a mostly bleak telecom industry.

They're losing lines — but at only half the rate of the Bells. Ninety-two percent of them offer broadband. About a third run wires outside their home turf to compete with neighboring carriers — something the Bells have never done.

"These aren't rinky-dink facilities," says Washington lawyer Andrew Lipman, who represents rural providers. "Many are more up-to-date than the Bells, and they're more focused and more local."

### Guaranteed profit

But rural providers note their access fees and universal service revenue are falling as more consumers shift their long-distance calls to wireless and Internet-based services. Those services pay low or no access and universal service fees.

Complicating the issue are complaints that at least some rural companies milk the system. One big problem, some say: The government guarantees the rural companies an 11.25% return on their network investments. They can recoup all their operating and capital costs, plus net a profit of 11.25%.

### OVERHAULING SUBSIDIES

The federal subsidies that sustain rural phone companies are likely to be overhauled by regulators as early as next year. That worries the providers that depend on the subsidies for at least half of their revenue.

One big subsidy: the \$4 billion in fees that long-distance companies pay rural phone companies to connect long-distance calls to rural customers.

These "access fees" are complex. Long-distance carriers pay an average per-minute charge of a half-cent to connect an interstate call to a regional Bell, 2 cents to send the same call to a rural company and 5 cents to connect an in-state call to a rural provider.

Those disparities lead long-distance companies to reroute calls to get the lowest rate or shift calls to Internet-based phone services.

Some big phone companies have proposed that the Federal Communications Commission phase out the access fees by 2009. To offset that loss, a local-phone surcharge of up to \$6.50 a month, paid by all customers around the USA, would rise to as much as \$10. In rural areas, the surcharge would rise to \$9.

But rural areas would still see a shortfall. It would be offset by boosting the \$3.3 billion in universal service fees that fund rural phone service. Instead of the current 8.9% fee on long-distance bills, which are falling, a flat fee could be assessed on each connection whether cable broadband, Internet-based or wireless. That could raise \$2.5 billion more in universal service revenue.

But rural companies resist local rate increases. They also worry that some lawmakers would oppose anything that looks like a tax on broadband services. Alternative rural plans would create uniform access fees across the country, without raising most rural phone rates.

you spend, then you are not (motivated) to reduce your costs," says Stanton, at Western Wireless.

Another gripe: that rural companies overestimate their costs or underestimate customer demand. That causes the FCC to raise access rates too high the next year. Long-distance companies recently told the FCC that rural companies have paid pockets in each of the past nine years. The FCC is investigating the claims.

XIT is among at least four Texas phone cooperatives since 1999 that have paid their customers dividends that equaled or exceeded their phone charges, according to Texas state records. Each co-op also gets at least \$1 million in federal universal service fees.

"They're doing it with money you and I supplied," says Austin lawyer Larry Smith, who represents rivals to the rural cooperatives.

But White says without universal service revenue, "it wouldn't be long before we went out of business."

Another criticism: that some rural companies spend freely with little oversight. New York prosecutors, for example, say the Gambino crime family used Cass County Telephone in Peculiar, Mo., to launder proceeds from a scheme to slap up charges across the country with unauthorized charges. CassTel drew millions in universal subscriber funds to pay exorbitant the "computer consulting" services of a firm that facilitated the scheme, according to prosecutors. A trial is set for next year.

### High overhead, low oversight

In a study commissioned by Western Wireless, telecom consulting firm Economics and Technology says rural carriers have "inefficiencies are substantial." Examples it cites:

- Big Bend Telephone of Alpine, Texas, which serves 6,000 customers, last year had \$3.6 million in corporate overhead — such as accounting and human resources — or 25% of its operating expenses.

Some similar-sized companies had much lower corporate expenses, Economics and Technology says. Example: Valley Telephone Cooperative of Westby, Wis., with 7,500 lines, had just \$747,000 in such corporate costs.

Meanwhile, Big Bend last year got \$9.6 million in federal universal service funds, \$3.3 million in state universal service funds and \$18 million in access fees. (Less than 5% of revenue was from local charges.)

Big Bend President Justin Haynes calls the figures misleading. He says his managers do line work and are included in corporate overhead:

"I've got managers out there in the ditch doing physical work. We have 6,000 customers spread over 18,000 miles of mountains and rocks. Providing telephone service here is very costly."

Still, the utility posted a 12.8% return last year. And it paid shareholders a \$3 million dividend. In 2002, it shelled out \$1 million dividend. It also runs a "hunting ranch" to entertain rural phone lobbyists at a cost of \$80,000 a year. Haynes comments on the dividends:

- Doylestown Telephone, which serves 4,100 customers in Doylestown, Ohio, has about \$4.3 million in cash and has \$7.5 million in an affiliate that provides Internet, cable and other services. The affiliate also offers rural phone, Web and other services in neighboring towns served mainly by Sprint's local phone unit. Sprint has been slow to roll out advanced services in those areas.

Doylestown earned a 20% return last year and got \$400,000 in federal universal service money and \$2.6 million in state universal service funds.

Customers pay \$12.80 in local rates. It's "cash-rich," says analyst Scott Lundquist of Economics and Technology. "Why is it getting \$400,000 a year in federal subsidies?"

Doylestown President Tom Brockman says the company plays by the rules. It doesn't pay big dividends and "likes to have a nest egg available for projects."

•Union Telephone, which serves 8,000 lines in Mountain View, Wyo., saw its employee base rise 24% this year, its marketing costs soar 80% and its building expenses jump 64%. Vice President John Woody says marketing and building costs rose as its cell phone business grew. But state regulators say cell phone costs are supposed to be funded apart from regulated phone expenses.

Rural phone officials say the huge majority of the companies are efficient. Corporate overhead can depend on the "remoteness" of an area, economist Dale Lehman says in a report for NTCA.

"If (critics) believe there's a lot of waste in the system, they can challenge the carriers" before state regulators, Mitchell says.

But state regulators have few resources to scrutinize the finances of dozens of rural companies, says Brad Ramsey, general counsel of the National Association of Regulatory Utility Commissioners.

Tom Bennett, the FCC's assistant inspector general, concedes his agency lacks the staff to audit rural-fund recipients. The Universal Service Administrative Company, which disburses the money for the FCC, has done just seven audits since 1998, says spokesman Mel Blackwell. But next year, the USAC plans to do 15 and is allocating money for outside auditors to do 250.

"Are we concerned about abuse? Absolutely," Bennett says. "And we're trying to ... address it."

Regulators are considering a plan to modify universal service funding so rural companies would not be reimbursed for their actual network and operating costs. Instead, they'd be paid based on the hypothetically most efficient way to serve a customer.

Some doubt that a plan to sharply restrict rural funding could be enacted. "There's a very strong rural lobby in America, and to bet against them historically has been a pretty bad bet," says analyst Tavis McCourt of Morgan Keegan.

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